

CANBAIKAL RESOURCES INC.
Financial Statements
Year Ended December 31, 2004

CANBAIKAL RESOURCES INC.

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Year Ended December 31, 2004

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AUDITORS' REPORT

To the Shareholder of CanBaikal Resources Inc.

We have audited the balance sheet of CanBaikal Resources Inc. as at December 31, 2004 and the statements of income, deficit and cash flow for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2004 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Allen, Moore & Company LLP

Calgary, Alberta
August 8, 2005

CHARTERED ACCOUNTANTS

CANBAIKAL RESOURCES INC.

Balance Sheet

December 31, 2004

	2004	2003
ASSETS		
CURRENT		
Cash	\$ 483,225	\$ 994,415
Accounts receivable	394,093	787,959
Inventory	129,563	139,694
Prepaid expenses	456,270	709,034
Due from related parties (Note 10)	23,572	905,216
	1,486,723	3,536,318
PROPERTY AND EQUIPMENT (Note 4)	43,579	42,576
PETROLEUM PROPERTIES AND EQUIPMENT (Note 6)	20,240,428	12,153,429
FUTURE TAX ASSET	2,025,000	2,619,233
TAXES RECOVERABLE	2,407,413	1,465,184
	\$ 26,203,143	\$ 19,816,740
LIABILITIES AND SHAREHOLDER'S EQUITY		
CURRENT		
Accounts payable	\$ 7,696,297	\$ 2,500,148
Income taxes payable	92,143	155,621
Current portion of long term debt (Note 9)	902,700	3,877,200
Due to shareholder	806,412	-
Wages payable	28,390	-
	9,525,942	6,532,969
Callable debt due thereafter (Note 8)	1,062,805	1,081,897
	10,588,747	7,614,866
LONG TERM DEBT (Note 9)	4,155,621	3,152,678
DUE TO RELATED PARTIES (Note 10)	-	2,970,361
ASSET RETIREMENT OBLIGATION (Note 5)	389,103	16,061
	15,133,471	13,753,966
SHAREHOLDER'S EQUITY		
Share capital (Note 11)	13,871,226	10,645,903
Deficit	(2,801,554)	(4,583,129)
	11,069,672	6,062,774
	\$ 26,203,143	\$ 19,816,740

ON BEHALF OF THE BOARD

_____ Director

_____ Director

CANBAIKAL RESOURCES INC.**Statement of Income****Year Ended December 31, 2004**

	2004	2003
REVENUE		
Resale of oil products	\$ 11,686	\$ -
Sales from oil and gas properties	11,739,946	5,881,803
	<u>11,751,632</u>	<u>5,881,803</u>
EXPENSES		
Amortization and site restoration costs	2,386,321	1,554,793
Interest on long term debt	286,156	526,080
General and administrative expenses	1,505,490	1,238,614
Operating	5,493,936	2,686,921
	<u>9,671,903</u>	<u>6,006,408</u>
INCOME (LOSS) FROM OPERATIONS	<u>2,079,729</u>	<u>(124,605)</u>
OTHER INCOME		
Gain from foreign exchange	717,359	769,190
Other income	60,837	41,711
	<u>778,196</u>	<u>810,901</u>
INCOME BEFORE INCOME TAXES	<u>2,857,925</u>	<u>686,296</u>
INCOME TAXES		
Current	168,250	155,621
Future	594,233	422,909
	<u>762,483</u>	<u>578,530</u>
NET INCOME	<u>\$ 2,095,442</u>	<u>\$ 107,766</u>

CANBAIKAL RESOURCES INC.

Statement of Deficit

Year Ended December 31, 2004

	2004	2003
DEFICIT - BEGINNING OF YEAR	\$ (4,583,129)	\$ (4,690,895)
NET INCOME FOR THE YEAR	<u>2,095,442</u>	<u>107,766</u>
	(2,487,687)	(4,583,129)
LOSS ON AMALGAMATION	<u>(313,867)</u>	-
DEFICIT - END OF YEAR	<u>\$ (2,801,554)</u>	<u>\$ (4,583,129)</u>

CANBAIKAL RESOURCES INC.

Statement of Cash Flow

Year Ended December 31, 2004

	2004	2003
OPERATING ACTIVITIES		
Net income	\$ 2,095,442	\$ 107,766
Items not affecting cash:		
Amortization	2,386,321	1,554,793
Future income taxes	594,233	422,909
Loss on amalgamation	(313,868)	-
	<u>4,762,128</u>	<u>2,085,468</u>
Changes in non-cash working capital:		
Accounts receivable	393,866	(784,875)
Inventory	10,131	(139,694)
Accounts payable	5,196,149	1,769,517
Income taxes payable	(63,478)	155,621
Prepaid expenses	252,764	(296,926)
Wages payable	28,390	-
Taxes Recoverable	(942,229)	(1,059,922)
	<u>4,875,593</u>	<u>(356,279)</u>
Cash flow from operating activities	<u>9,637,721</u>	<u>1,729,189</u>
INVESTING ACTIVITIES		
Purchase of equipment	(15,646)	(21,975)
Proceeds on disposal of equipment	-	9,461
Additions to petroleum, natural gas properties and equipment	(10,085,634)	(7,708,168)
Cash flow used by investing activities	<u>(10,101,280)</u>	<u>(7,720,682)</u>
FINANCING ACTIVITIES		
Advances from (repayments to) affiliates	254,962	(957,592)
Advances from related parties	881,644	-
Advances from shareholder	806,412	-
Proceeds from callable debt financing	23,777	-
Proceeds from long term financing	1,706,401	7,029,878
Repayment of callable debt	(42,869)	-
Repayment of long term debt	(3,677,958)	-
Short term loans	-	636,936
Cash flow from (used by) financing activities	<u>(47,631)</u>	<u>6,709,222</u>
INCREASE (DECREASE) IN CASH FLOW	(511,190)	717,729
Cash - beginning of year	<u>994,415</u>	<u>276,686</u>
CASH - END OF YEAR	\$ 483,225	\$ 994,415
CASH FLOW SUPPLEMENTARY INFORMATION		
Interest paid	\$ 286,157	\$ 526,080
Income taxes paid	\$ 231,729	\$ -

CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

1. NATURE OF OPERATIONS AND BUSINESS RISKS

The company is incorporated under the laws of Alberta and is engaged primarily in the exploration for and development of petroleum and natural gas in Russia. Since inception, the efforts of the Company have been devoted to the acquisition of exploration and production licenses and the development thereof. On January 28, 2002, the Company was acquired by a private company incorporated under the laws of Alberta. Effective January 1, 2004 the Company amalgamated with its parent company, C.B. Acquisition Ltd. The amalgamated company will be continued under the name CanBaikal Resources Inc. The ultimate parent company is a Cyprus company whose principal business is the trading of oil and oil products from the Russian Federation.

All of the Company's petroleum and natural gas operations are based in Russia as a result of the sale of the Canadian properties in a prior year. The political situation, income tax legislation, banking regulations and the general operating environment are changing continuously as Russia makes the transition from a command to a market oriented economy. The Company's operations and financial position will continue to be affected by Russian political developments including the application and interpretation of existing and future legislation and regulations pertaining to petroleum and natural gas exploration and production, imports, exports and income tax. It is possible that these developments may have significant impact on the Company's ability to continue operations. The likelihood of such developments is not determinable. Management is continuously monitoring potential developments and changes as they occur.

Continuation of the Company as a going concern is dependent upon obtaining additional capital and/or achieving consistently profitable operations. The financial statements do not include any adjustments relating to the realization of assets and liquidation of liabilities that might be necessary should the Company be unable to continue as a going concern.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of significant accounting policies summarized below:

Cash and short term investments

Cash and cash equivalents consist primarily of cash on hand, bank balances and short term investments with an original maturity date of purchase of three months or less. Because of the short term maturity of these investments, their carrying amount approximates fair value.

Inventory

Inventories of petroleum products, operating supplies and raw materials are valued at the lower of cost and net realizable value.

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CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Property and equipment

Property and equipment assets are stated at cost less accumulated amortization and are amortized over their estimated useful lives at the following rates and methods:

Office equipment and leaseholds	20%	declining balance method
Motor vehicles	30%	declining balance method
Computer equipment	30%	declining balance method

The Company regularly reviews its capital assets to eliminate obsolete items. Government grants are treated as a reduction of capital asset cost.

Petroleum properties and equipment

The Company follows the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized. Such costs include land acquisition, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment, are depleted and amortized on the unit-of-production method based on estimated gross proved reserves as determined by independent petroleum engineers. Petroleum products and reserves are converted to a common unit of measure, using 6 MCF of natural gas to 1 barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

Proceeds from a sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion by more than 20%.

The Company applies an impairment test ("ceiling test") to determine if capitalized costs are not recoverable and exceed their fair value. Capitalized costs are not recoverable if they are greater than estimated undiscounted cash flows from future production of proven reserves plus the cost (net of impairment) of unproved properties. Commodity prices used in calculating estimated cash inflows are based on quoted benchmark prices in the futures market. Costs used in estimating cash outflows are based on expected future production and other costs and include abandonment and site restoration costs. The impairment loss is measured as the amount by which capitalized costs exceed fair value of proved and probable reserves plus the cost (net of impairment) of unproved properties. Fair value is determined based on the present value of future cash flows, after deducting abandonment and site restoration costs, discounted at a risk-free interest rate. Any impairment loss is charged to retained earnings.

Future income taxes

The liability method of tax allocation is used in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities, and measured using the substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

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CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Foreign currency translation

Accounts in foreign currencies have been translated into Canadian dollars using the temporal method. Under this method monetary assets and liabilities have been translated at the year end exchange rate. Non-monetary assets have been translated at the rate of exchange prevailing at the date of transaction. Revenues and expenses have been translated at the average rates of exchange during the year, except for amortization, which has been translated at the same rate as the related assets.

Foreign exchange gains and losses on monetary assets and liabilities are included in the determination of earnings.

Measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Such estimates include providing for amortization of property, plant & equipment and goodwill. Actual results could differ from these estimates.

The financial statements include amounts based on the terms of the interpretation

Asset Retirement Obligations

Asset retirement obligations are recognized in the period in which they are incurred if a reasonable estimate of fair value can be determined. The liability is measured at fair value and is adjusted in subsequent periods as accretion expense is recorded. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset, and the asset is depreciated over the asset's estimated useful life.

Revenue recognition

Revenues are net of taxes directly related to oil production and are normally recognized when the products are shipped, at which time title passes to the customer.

Stock-based compensation plan

The Company measures all stock based compensation based on fair value method of accounting and recognizes the compensation expense in the financial statements.

3. FINANCIAL INSTRUMENTS

The Company's financial instruments consist of cash, accounts receivable, due from shareholder, investment, accounts payable and accrued liabilities. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair value of these financial instruments approximate their carrying values, unless otherwise noted.

CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

4. PROPERTY AND EQUIPMENT

	Cost	Accumulated amortization	2004 Net book value	2003 Net book value
Motor vehicles	\$ 28,003	\$ 7,157	\$ 20,846	\$ 19,711
Computer equipment	24,983	6,546	18,437	18,660
Furniture and fixtures	5,236	940	4,296	4,205
	\$ 58,222	\$ 14,643	\$ 43,579	\$ 42,576

5. ASSET RETIREMENT OBLIGATION

Asset retirement obligations are applicable to and associated with petroleum properties. These obligations generally relate to dismantlement and site restoration.

Present value of assets legally restricted for purposes of settling asset retirement obligation is estimated to be \$324,149 as at December 31, 2004. The liability is expected to be settled over the next 14 years

	2004	2003
Carrying amount, beginning of year	\$ 164,643	\$ -
Increase in liability during the year	189,087	-
Subtotal	353,730	-
Accretion expense	35,373	-
	\$ 389,103	\$ -

The carrying amount of the asset retirement obligations is based on the following assumptions:

Abandonment costs, per well	\$90,270
Inflation rate	1,5%
Inflation factor for 15 years	1,25
Expected cash flow adjusted for inflation	112,838
Credit-adjusted risk free rate	10%
Estimated useful life	15 years
Present value, per well	27,012

CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

6. PETROLEUM PROPERTIES AND EQUIPMENT

	<u>2004</u>	<u>2003</u>
Capitalized costs	\$ 25,032,870	\$ 14,947,236
Long lived asset	324,149	-
Long lived asset - acc. depletion	(39,618)	-
Capitalized costs - acc. depletion	<u>(5,076,973)</u>	<u>(2,793,807)</u>
	<u>\$ 20,240,428</u>	<u>\$ 12,153,429</u>

During 2004, \$ NIL (2003 - nil) of overhead expenses directly related to exploration and development activities were capitalized.

Future capital expenditures of \$13,778,000 (2003 - \$31,779,000) as estimated by independent engineers, relating to the development of proved non-producing reserves have been included in costs subject to depletion. As at December 31, 2003, costs of acquiring unproved properties in the amount of approximately \$ 905,000 were excluded from depletable assets.

An impairment test calculation was performed on the Company's petroleum property and equipment at December 31, 2003 in which the estimated undiscounted future net cash flows associated with the gross proved reserves exceeded the carrying amount of the Company's petroleum properties and equipment. Although such a test was not performed in 2004, a new survey will be completed in 2005. The adjustment, if any to the carrying value of the company's petroleum and natural gas assets, has not been reflected in the financial statements. It is the estimate of management that no such adjustment is required.

The following table outlines the benchmark prices used in the impairment test at December 31, 2003:

Year	Siberian Blend US \$/bbl	Pipeline Transportation Fee US \$/bbl	Export Wellhead Oil Price US \$/bbl	Domestic Wellhead Oil Price US \$/bbl Including VAT	Wellhead to Export Wellhead Price Ratio
2004	30.25	2.00	28.25	19.78	70%
2005	24.96	2.03	22.93	17.20	75%
2006	22.92	2.06	20.86	16.69	80%
2007	20.89	2.09	18.79	15.04	80%
2008	20.85	2.12	15.72	14.98	80%
Therafter (inflation %)	1.5%/yr	1.5%/yr	1.5%/yr	1.5%/yr	N/A

CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

7. INCOME TAXES

	<u>2004</u>	<u>2003</u>
Future income tax asset consists of the following temporary differences:		
Petroleum and natural gas properties	\$ 441,574	\$ 2,018,189
Capital loss carry-forwards	109,752	-
Share issue and finance costs	64,800	106,626
Eligible capital expenditures	53,312	57,325
Capital assets	1,355,562	-
Non-capital loss carry-forwards	-	361,318
Foreign tax credits	-	75,775
	<u>\$ 2,025,000</u>	<u>\$ 2,619,233</u>

The actual income tax provision differs from the expected amount calculated by applying the Canadian combined federal and provincial income tax rate to loss before income taxes. The major components of these differences are explained as follows:

Income (loss) before income taxes	\$ 2,857,925	\$ 686,296
Corporate tax rate 2004 - 39% (2003 - 39%)	0.39	0.39
Expected tax provision (recovery)	1,139,923	267,655
Financing fees	(45,310)	(86,400)
Other	-	9,104
Rate adjustment	(408,237)	232,550
Foreign taxes	76,107	155,621
	<u>\$ 762,483</u>	<u>\$ 578,530</u>

For income tax purposes, subject to approval by taxation authorities, the Company has losses in the approximate amount of \$ NIL (2003 - \$ 1,003,000) available to be carried forward to reduce taxable income for future years. These losses expire as follows:

2006	\$ -	\$ 663,500
2007	-	293,100
2009	-	46,400
	<u>\$ -</u>	<u>\$ 1,003,000</u>

The Company has available the following amounts which may be deducted, at the annual rates indicated, in determining taxable income for Canadian income tax purposes for future years:

Undepreciated capital costs 30 - 100%	\$ 3,811,000	\$ 2,850,000
Foreign exploration and development expense 10%	21,182,000	14,935,000
Cumulative eligible capital 7%	148,000	159,000
Financing and share issue costs 20%	180,000	296,000
	<u>\$ 25,321,000</u>	<u>\$ 18,240,000</u>

The Company is required to file tax returns in each of the jurisdictions in which it operates. The prime operating jurisdictions are Canada and Russia.

The Company has approximately \$ NIL (2003 - \$ 210,000) of foreign tax credits available to reduce taxable income from taxable income generated as a result of its operations in Russia.

The amount of taxes recoverable represents VAT recoverable, which is a Russian Value Added Tax.

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CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

7. INCOME TAXES *(continued)*

The balance in the account with the Government can only be offset against future liabilities, and never refunded in cash. The amount recorded as a long term asset is based on the interpretation of existing tax legislation in Russia. The accrual made by management may be significantly different from that determined by the taxation authorities and as a result is subject to measurement uncertainty. The effect on the financial statements resulting from such adjustments, if any, will be reflected prospectively.

8. CALLABLE DEBT

	<u>2004</u>	<u>2003</u>
TD Petrotek, a company controlled by the ultimate shareholders is unsecured, non interest bearing and matures on December 31, 2004 (Note 13(b)).	\$ 641,228	\$ 684,097
Petrotek-Pererabotka, a company controlled by the ultimate shareholders, is due in December 2004. The loan is unsecured, bears interest at 1% per annum after March 31, 2003 (Note 13(b)).	<u>421,577</u>	<u>397,800</u>
	1,062,805	1,081,897
Principal due in one year	<u>-</u>	<u>-</u>
	\$ 1,062,805	\$ 1,081,897

Comments regarding callable debt

9. LONG TERM DEBT

	<u>2004</u>	<u>2003</u>
Select Energy Trading GmbH US dollar loan bearing interest of 1-month LIBOR plus a margin of 6.25% for an effective rate of 7.6% per annum, repayable in monthly payments of USD \$250,000 plus interest. The loan matures on February 28, 2005 and is secured by a general security agreement. As a condition of the loan the company has agreed to sell 5,000 mtons per month of its oil production eligible for export to the lender at the prevailing market price until February 2005.	\$ 902,700	\$ 4,523,400
Petrotek-Pererabotkak loan is non-interest bearing, with no fixed terms of repayment. The loan matures on January 14, 2008 and is unsecured.	516,312	525,587
Petrotek-Pererabotka loan is non-interest bearing with no fixed terms of repayment. The loan matures on July 1, 2008 and is unsecured.	1,932,908	1,980,891
Novation Trading Ltd. loan is non-interest bearing with no set terms of repayment. The loan matures on September 7, 2008 and is unsecured.	<u>1,706,401</u>	<u>-</u>

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CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

9. LONG TERM DEBT *(continued)*

	2004	2003
	5,058,321	7,029,878
Amounts payable within one year	(902,700)	(3,877,200)
	\$ 4,155,621	\$ 3,152,678

10. DUE FROM (TO) RELATED PARTIES

	2004	2003
C.B Acquisition Ltd.	\$ -	\$ (2,933,479)
Novation Trading Limited	23,572	868,334
	\$ 23,572	\$ (2,065,145)

The amount due to Novation Trading Limited ("Novation") is unsecured, bearing interest at 10% and is due on December 31, 2007. The amount due to C.B. Acquisition Ltd. ("C.B.") has no set terms of repayment, is unsecured and non-interest bearing.

11. SHARE CAPITAL

	2004	2003
Authorized:		
Unlimited Common voting shares		
Unlimited Preferred shares, issueable in series		
Issued:		
- Common shares	\$ 13,871,226	\$ 10,645,903

On January 1, 2004, the company amalgamated with its parent C.B. Acquisition Ltd. at which time 28,573,616 shares having a value of \$ 10,645,903 were replaced with shares of the parent company having a value of \$13,871,226. Since no cash was used in this transaction, the increase in share capital has not been included in the statement of cash flow.

CANBAIKAL RESOURCES INC.

Notes to Financial Statements

Year Ended December 31, 2004

12. RELATED PARTY TRANSACTIONS

Except as noted elsewhere in these financial statements, the Company had the following transactions with related parties:

	<u>2004</u>	<u>2003</u>
Novation Trading Limited <i>(A company controlled by the ultimate parent company)</i> Loan to the Company	\$ 1,706,421	\$ 2,690,202
AB Technologies <i>(A company related by virtue of common management)</i> Administration fees of \$ 3,000 US per month	-	36,000
Petrotech-Neft <i>(A company controlled by the ultimate shareholders)</i> Advances by Company to conduct seismic exploration program	-	880,496
	<u>\$ 1,706,421</u>	<u>\$ 3,606,698</u>

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

13. CONTINGENT LIABILITY

Under the Russian exploration and production license agreement, the taxes and payments required to be paid by the Company include: 1% of estimated exploration, evaluation costs; 3% of the estimated exploration costs for delineation wells; 7% of the value of production; and other taxes stipulated by the authorities.

The Company is subject to various regulatory requirements relating to the protection of the environment. Any changes in these estimates will affect future earnings. Costs attributable to these commitments and contingencies are expected to be incurred over an extended period of time and are to be funded mainly from the Company's cash provided by operating activities.

The operations of the Company are complex, related tax interpretations, regulations and legislation affecting the Company are continually changing. although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.
